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BEFORE THE ARIZONA CORPORATION COMMISSION

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CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

2002 JUL 10 A 11:45

ARIZONA CORPORATION COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF ARIZONA PUBLIC SERVICE) DOCKET NO.
COMPANY'S REQUEST FOR A VARIANCE OF) E-01345A-01-0822
CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606)
IN THE MATTER OF THE GENERIC PROCEEDINGS) DOCKET NO.
CONCERNING ELECTRIC RESTRUCTURING.) E-00000A-02-0051
IN THE MATTER OF TUCSON ELECTRIC POWER)
COMPANY'S APPLICATION FOR A VARIANCE OF) DOCKET NO.
CERTAIN ELECTRIC COMPETITION RULES) E-01933A-02-0069
COMPLIANCE DATES.)
IN THE MATTER OF THE APPLICATION OF) DOCKET NO.
TUCSON ELECTRIC POWER COMPANY FOR) E-01933A-98-0471
APPROVAL OF ITS STRANDED COST RECOVERY.)
IN THE MATTER OF THE GENERIC PROCEEDING) DOCKET NO.
CONCERNING THE ARIZONA INDEPENDENT) E-00000A-01-0630
SCHEDULING ADMINISTRATOR)

AUIA'S CLOSING BRIEF
IN THE TRACK A PROCEEDING

The Arizona Utility Investors Association (AUIA) hereby files its closing brief in the above-captioned proceeding, according to the instructions issued by the Chief Administrative Law Judge (CALJ) at the close of hearing, June 21, 2002.

The Siamese Dilemma

AUIA believes that this evaluation process is seriously flawed in the way it has been bifurcated into separate proceedings. In Track A, the parties are trying to resolve the divestiture of APS generating assets while a procedure is being developed across the hall, as it were, in Track B to initiate a competitive bidding process.

The CALJ has no assignment in Track A to consider modifications to the competitive solicitation and bidding requirements of R14-2-1606(B). Likewise, as APS witness Jack Davis noted, there has been no discussion of the financial health of the utility or the impact of these issues on its ability to attract and retain capital.¹

Arizona Corporation Commission

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1. See Davis Rebuttal P. 13

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1 To that we would add that there also has been no consideration given
2 to the disposition of APS' assets if divestiture is denied and competitive
3 bidding goes forward.

4 The assignment here, according to the procedural Order of May 2,
5 2002, is to address "the transfer of assets and associated market power issues,
6 as well as the issues of the Code of Conduct, the Affiliated Interest Rules, and
7 the jurisdictional issues raised by Chairman Mundell..."²

8 Yet, the transfer of assets required by R14-2-1615 is joined at the hip
9 with the competitive solicitation required in R14-2-1606(B) and cannot be
10 separated. The parameters of this relationship are relatively straight forward.
11 The extent of competitive solicitation is circumscribed by APS' ability to
12 divest its assets, to wit:

13 • If APS cannot transfer its assets to an affiliate, it cannot conduct an
14 arms-length competitive solicitation because it will continue to have direct
15 ownership control over most of the generating facilities that will be required
16 to serve its standard offer customers.

17 • If APS cannot transfer its assets, they will remain under cost-of-
18 service (COS) regulation,³ which assures the utility an opportunity to earn a
19 fair rate of return on its investment in those assets.

20 • If APS assets remain under COS regulation, it is Staff's view that the
21 bidding process would necessarily be limited to standard offer load not
22 currently served by APS generating facilities that are in rate base.⁴

23 • It is conceivable that Track B could produce a bidding process that
24 would lead to replacing some rate-based generation with competitively-bid
25 resources. However, that would produce a legal and regulatory quagmire
26 concerning the division of APS' assets between regulated and unregulated
27 uses. That is probably why Staff witness Matthew Rowell was emphatic in
28 asserting that the Staff had no intention of displacing rate-based facilities with
29 competitively-bid generation.⁵

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31 2. See Procedural Order May 2, 2002, P. 1

32 3. See Rowell Supplemental, P. 1

33 4. See Rowell Cross., Tr. P. 1620

34 5. See Rowell Cross., Tr. P. 1620

1 In summary, unless and until APS can transfer its generating assets to an
2 affiliate, wholesale competition for APS' load must be a limited proposition.

3 4 **A Fork in the Road: Market Power**

5 As a famous humanist once said, "When you reach a fork in the road, take it."
6 That's what APS and the Staff have done. After starting at about the same place,
7 they take different paths to a similar destination.

8 Both the Staff and APS have expressed concern that the western wholesale
9 market is too thin to support the bidding requirement in 1606(B) and that it remains
10 volatile and unpredictable in the aftermath of California. APS cites trends favoring a
11 more competitive wholesale market since 1999, the year it negotiated its Settlement
12 Agreement, including the divestiture provision.⁶

13 However, the Staff's attention is focused on perceived market power. Staff
14 witnesses asserted that APS currently has market power which it would simply
15 confer on an affiliate if it transferred its generation assets to Pinnacle West Energy
16 Corporation (PWEC).⁷

17 APS' global solution to these concerns, expressed in its Request for Variance,
18 is to enter into a Commission-approved, long-term, cost-based purchased power
19 agreement (PPA) with PWEC which would keep its generating assets tied to the
20 needs of its standard offer customers while allowing wholesale bidding for
21 incremental amounts of load.

22 The Staff has rejected the idea of the PPA, in part because it would allegedly
23 inhibit the development of a competitive market. Yet, it is unclear today whether
24 Staff favors competitive solicitation on any significant scale.⁸ It appears that Staff
25 prefers a continuation of cost-of-service regulation while the Commission examines
26 the long-term viability of competition.⁹

27 However, if competition and divestiture go hand in hand, Staff wants to focus
28 on curtailing market power. Staff's recommended approach is to condition APS'
29 divestiture upon the completion and approval of a market power study
30 accompanied by appropriate mitigation measures.¹⁰

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32 6. See Davis Rebuttal, P. 19

33 7. See Rowell Direct, P. 7-8

34 8. See Rowell Cross., Tr. P. 1615

35 9. See Rowell Supplemental, P. 1

36 10. See Rowell Direct, P. 10

1 Staff also desires a study of the economic validity of continued use of
2 Reliability Must-Run (RMR) generation by APS in the Phoenix load pocket. Finally,
3 if a utility does divest, any subsequent purchases from an affiliate would be
4 subjected to greater scrutiny than third-party transactions.¹¹

5 If the Staff's recommendations were adopted, it is anyone's guess how long it
6 would take for APS to deal with market power issues to the Commission's
7 satisfaction.¹² In fact, there is no assurance that the proposed study and mitigation
8 measures would ever be approved and divestiture allowed.

9 AUIA believes that the threat of market power has been vastly overstated in
10 this proceeding.

11 Leaving RMR aside, APS witness Hieronymus testified that APS has no
12 market power, based on tests accepted by the Federal Energy Regulatory
13 Commission (FERC).¹³ Without plodding through the grimy details, let it be said
14 that Staff and some intervenors argued vigorously to the contrary. Given the stark
15 differences in analysis, it is hard to imagine that another market power study
16 performed by APS would be decisive.

17 However, these were all theoretical exercises. The definition of market power
18 is the ability of an entity to profitably elevate and sustain the price of a product
19 above a competitive level.¹⁴ So far, no one has explained how this power would
20 actually manifest itself in the APS market. Would PWEC withhold energy or
21 capacity from the market (or from APS) in order to inflate the price that its UDC
22 affiliate would have to pay for power? Given the Commission's oversight capability
23 and its ultimate ratemaking authority, that would seem dangerous if not suicidal.

24 In fact, the solution to the threat of market power probably can be found in
25 Track B. As APS witness Hieronymus observed, the surest way to mitigate
26 perceived market power is to place all or most of APS' standard offer needs ¹⁵ and
27 most of its transferred generation assets under bilateral contracts. That would be the
28 end result of any competitive purchase scenario. ¹⁶

29
30 11. See Rowell Supplemental, P. 2-3

31 12. See Rowell Cross., Tr. P. 1618-19

32 13. See Hieronymus Direct, P. 36

33 14. See Hieronymus Direct, P. 23

34 15. See Hieronymus Rebuttal, P. 1-5

35 16. See Hieronymus Rebuttal, P. 11

1 **The End Result**

2 Virtually any conceivable competitive solicitation would produce
3 approximately the same end result in terms of jurisdiction and accountability. Both
4 competitive bidding by third-party suppliers and purchases negotiated between
5 APS and PWEC or other suppliers would have these common characteristics:

- 6 • The Commission would direct the process and exercise oversight and
7 reasonable control over the results.
- 8 • The process would produce bilateral contracts between APS and PWEC
9 and between APS and third-party suppliers.
- 10 • Once executed, further approval and subsequent administration and
11 interpretation of the contracts would come under FERC jurisdiction.
- 12 • The Commission would retain the right to initiate or intervene in
13 contract-related actions at FERC.
- 14 • The Commission would retain the ability, under its ratemaking authority,
15 to disallow any charges deemed to be imprudent, as that term is construed in
16 regulatory law.

17
18 **The Settlement Agreement**

19 As APS witness Davis pointed out, the testimony submitted by Staff in this
20 proceeding has completely ignored the 1999 Settlement Agreement.¹⁷

21 That document not only ratified the need for APS to transfer its generation
22 assets, but it provided for rate protection, future rate decreases and the write-off of
23 \$234 million of prudently incurred investment. In other words, utility customers,
24 shareholders and all of the signatories have a stake in the agreement and have a
25 right to rely on its terms. In addition, the financial community has relied on the
26 Settlement Agreement to help define APS' future.

27 Whether or not it is an enforceable contract, as APS believes,¹⁸ it would be
28 wholly improper for an order to issue from this proceeding that would violate the
29 Settlement Agreement without even a reference to it. At a minimum, the CALJ
30 should include appropriate findings of fact and conclusions of law regarding the
31 Settlement Agreement in any order that contradicts its provisions.

32
33 17. See Davis Rebuttal, P. 19

34 18. See Davis Cross., Tr. P. 93

1 **Conclusion**

2 It is clear that if APS is prohibited from transferring its generation assets or if
3 it is constrained for some period of time by the requirement to address market
4 power issues, then competitive solicitation of power supplies for APS' standard offer
5 customers must be severely limited in scope or delayed altogether. This would
6 require modifications to R14-2-1615 and R14-2-1606(B).

7 AUIA believes that this Commission has a legal and moral obligation to abide
8 by the terms of the 1999 Settlement Agreement it entered into with APS, absent a
9 demonstration that extraordinary circumstances have intervened since then. There
10 has been no such showing in this proceeding. If anything, APS has less market
11 power today than it did in 1999.

12 AUIA also believes that if the Commission maintains vigilance, it can safely
13 allow APS to transfer its assets to PWEC and conduct a competitive solicitation
14 within the limitations imposed by the marketplace. In the alternative, the
15 Commission can elect to perform a thorough examination of the PPA concept
16 proposed by APS.

17 If none of these options is acceptable, then the Commission should suspend
18 the electric competition rules and continue cost-of-service regulation until it has
19 completed a re-examination of electric competition in Arizona. This option would
20 obligate the Commission to allow APS to recover the transition costs it has incurred
21 to date at the earliest opportunity.

22
23 RESPECTFULLY SUBMITTED this 10th day of July, 2002,

24 
25 _____

26 WALTER W. MEEK, PRESIDENT

1 **CERTIFICATE OF SERVICE**

2
3 Original and eighteen (18) copies of this Brief
4 were filed this 10th day of July, 2002, with:

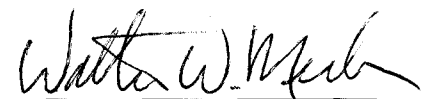
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31 Appropriate parties of record

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